LOTT & COMPANY
CHARTERED PROFESSIONAL ACCOUNTANTS

In Trusts We (Still) Trust:
Update on Tax Planning with Family Trusts

In an age where trustworthiness is rare in certain political arenas and in other necessaries of life, it can become difficult to be trusting towards others.

Fortunately, Family Trusts are still very trustworthy.

For tax purposes, the use of a trust can be a valuable estate and planning vehicle. In particular, Family Trusts provide a flexible and tax effective method to transfer family assets from one generation to the next.

In recent years, the legislative landscape for trusts has seen numerous changes, and even more revisions may be on the horizon. Nonetheless, with proper planning, Family Trusts remain a powerful and effective vehicle to reduce taxes for a family.

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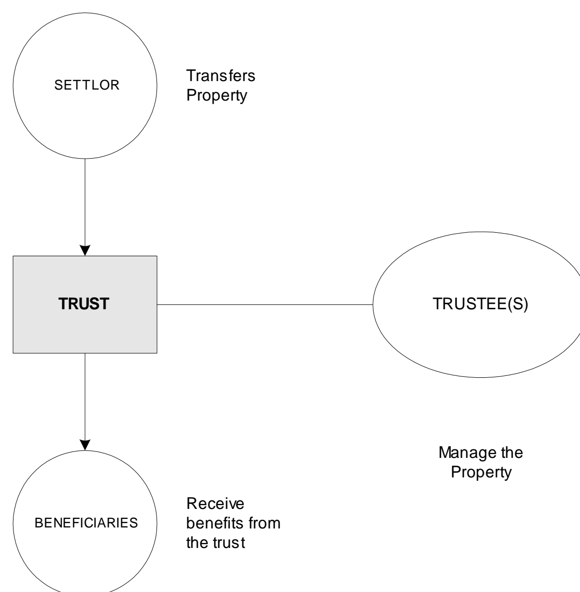
What is a Family Trust?

A trust is a legal arrangement created when a **settlor** transfers property to **trustees**, who hold and manage the assets for the benefit of **beneficiaries**. The settlor appoints the trustees to manage and control the assets of the trust, according to instructions of the settlor. A Family Trust is an *inter vivos* personal trust (i.e. set up during the settlor's lifetime) created to hold and administer family assets, such as a family cottage or other real estate, farm, investments or family businesses (including shares of private corporations).

As the following diagram indicates, the use of a trust



separates the management and control of an asset from the benefits of the ownership of the asset.

In a family situation, a trust can be created by one family member transferring property to one or more trustees (such as the parents) for the benefit of other family members (such as their children).

There are three key roles in a Family Trust arrangement:

Settlor – establishes (or "settles") the trust and contributes assets to it. The settlor generally is not involved after the trust is established.

Trustees – appointed by the settlor in the trust agreement to control and manage trust assets and the income earned therefrom. The trustees invest and dispose of assets, and allocate or distribute the trust's income and capital to the beneficiaries, all the while exercising their fiduciary responsibilities under the trust agreement's direction and their discretion.

Beneficiaries – receive financial benefits from the trust, and can be either *income beneficiaries* (entitled to share in the trust's income), *capital beneficiaries* (entitled to share in the trust capital), or both.

The income and capital beneficiaries need not be the same people. The trust agreement may specifically name the beneficiaries, or indicate that they would come from a specified group, such as children or grandchildren of the settlor (even if not yet born).

The relative participation of each beneficiary can be fixed or discretionary (i.e. the trustees to decide the amount and timing of the payment of capital or income out of the trust). In a non-discretionary trust, the trustees must make income and/or capital distributions in accordance with the terms of the trust agreement.

There is no legal requirement that the settlor, trustees and beneficiaries must be different. However, tax rules and planning goals will affect the selection of the roles. *Inter vivos* Family Trusts should be irrevocable, such that the settlor cannot revoke the trust terms or take back any trust assets after their transfer to the trust. Also, they have a life cycle that cannot exist in perpetuity.

A trust is a formal legal arrangement that differs from an "in-trust" account. In many "in-trust" relationships, a parent, as legal guardian, generally controls investment funds and may use the capital and income to pay child expenses. The "in-trust" arrangement is less flexible than a formal trust, and the taxation effects can differ as well.

Uses and Benefits of Family Trusts

A Family Trust can be very useful for managing, protecting and eventually passing on family assets to the family members. A trust is a **flexible** arrangement that can be tailored to meet specific family needs. Family Trusts are used for many purposes, including succession planning for businesses and estate planning. Also, they can be designed to deal with the specific needs of the beneficiaries (i.e. advanced age or a disability).

The potential **uses** and **benefits** of a Family Trust are numerous, and may include the following:

- allow for the benefits of asset ownership to be transferred to children, without transferring the control of the asset to them;
- facilitate an estate freeze, whereby a parent freezes the value of his/her interest in an asset (and thereby freezes the amount of gain that he/she would ultimately recognize to be taxed upon);
- allow the trustees up to 21 years to decide which beneficiaries will ultimately receive which assets;
- facilitate creditor proofing from claims against discretionary beneficiaries;
- facilitate income splitting within the family;
- limit probate fee exposure (Estate Administration Taxes) and safeguard against the introduction of inheritance taxes (Estate Taxes);
- facilitate a reduction in retirement income, and thus a reduced "clawback"[1] of Old Age Security benefits;
- provide access to multiple $800,000[2] small business capital gains exemptions ("CGE");
- protect a family business from *Family Law Act* claims;
- allow for the splitting of certain business income (e.g. management and technical services fees);
- facilitate estate planning and asset protection via the use of a non-resident trust; and
- facilitate charitable giving through the use of a charitable remainder trust.

Taxation of a Family Trust

An ***inter vivos***[3] trust is treated like an individual for income tax purposes. As such, a trust must calculate its income generated by the assets that it owns, file a tax return, and pay any taxes on its undistributed (or retained) income. However, trusts are not entitled to claim non-refundable tax credits. In addition, any income earned and retained by an *inter vivos* trust is taxed at the *top* marginal rate for individuals. For a trust in Ontario for the 2013 year, the rates are: 49.53%[4] on normal income (e.g. interest, rental income), 24.77% on capital gains, 33.85% on eligible dividends, and 36.47% on ineligible dividends.

In computing trust income subject to tax, there may be deducted amounts of the trust income *paid out* or *made payable* to beneficiaries. The amount paid or payable to the beneficiaries is, in turn, included in their personal income tax returns while retaining its original "tax" character (i.e. as interest, dividend income or capital gains). As such, the trust can serve as a conduit for income to flow through to its beneficiaries.

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[1]*The government imposes a special tax to clawback OAS payments if net income for the year exceeds a certain annual threshold. For 2013, the threshold is $70,954, and a full clawback occurs when net income exceeds $114,640.*

[2]*The CGE is increased from $750,000 to $800,000 for 2014 and beyond.*

[3] *An inter vivos trust is created by a settlor while living.*

[4]*The 49.53% includes the Ontario low and high rate surtaxes that apply when taxable income of an* inter vivos *trust exceeds $32,591 (low rate surtax) and $41,709 (high rate surtax). Below $41,709, the tax rate of the trust ranges from 42.16% to 44.79% on regular income, e.g. interest etc.*

Given that the trust pays income tax at the top personal tax rate, it is generally advisable that all trust income be either distributed or allocated annually to the income beneficiaries. The beneficiaries then include their share of the income in their personal tax returns and pay income tax thereon. With proper planning, their tax rate may be less than the rate that the trust would pay on the same income. This “income splitting” is discussed below.

In certain circumstances, it may be desirable that the trust retain, for tax purposes, income that it was in fact distributed to beneficiaries (for example, to utilize trust loss carryovers). Special tax rules permit a trust to elect to be taxed on a portion of income or capital gains, even if these amounts are paid to its beneficiaries in a year.

Testamentary trusts can be created when an individual dies and leaves benefits to be distributed to heirs or beneficiaries over a period of time.

Currently, estates and other trusts created in a will (testamentary trusts) pay income tax on their income at the same graduated rates as individuals. By creating a testamentary trust under a will, a ‘new’ taxpayer is created, which can provide annual tax savings for the beneficiaries (who otherwise could pay tax on income allocated to them at a higher marginal tax rate).

In the 2013 federal budget, the government indicated its intention to eliminate the tax benefits arising from taxing testamentary trusts and estates at graduated tax rates. In June 2013, detailed proposals were released, which seek to tax testamentary trusts at a *flat rate* equal to the top rate[5] of combined federal and provincial tax for individuals. Continuing estates would also be subject to this flat top-rate taxation starting immediately after the 36 months following the individual’s death. Under this proposal, estates could retain access to graduated rates for up to the first 36 months of their administration. These proposed measures would apply to existing and new testamentary trust arrangements for 2016 and later taxation years.

Income Splitting and Family Trusts

One common use of a Family Trust is to facilitate income splitting within a family. In a typical situation, one or both parents may have substantial income, while the children (including minors[6]) may not be fully using their low marginal tax rates or personal tax credits. In this case, tax savings could be achieved if a high-income parent transfers an income-generating asset to a trust established with lower tax rate family members as beneficiaries. If the trust income is passed through the trust to be taxed in the hands of the beneficiaries, then an overall income tax savings could occur – compared to the high-income parent maintaining ownership of the asset and being taxed on any income or gains generated therefrom.

There are a number a planning strategies that can lead to significant income tax savings, e.g., a low interest loan strategy whereby a family member with the higher income loans cash or assets to the Family Trust where a spouse, child or grandchild who earns a lower income and is in a lower tax bracket are the beneficiaries.

In the private business context, a Family Trust can be used to split dividend income and multiply access to the small business capital gains exemption.

Attribution Rules

For *inter vivos* Family Trusts, the potential application of the “income attribution” rules must be considered. These rules can apply where a parent gifts property or makes a low or non-interest bearing loan to another family member. They apply to gifts and loans made directly by the parent, and indirectly through a trust. The rules apply differently depending on who is the recipient of the loan or gift.

In this regard, there are three distinct classes of recipients potentially affected by the different attribution rules – spouse, adult children, and minor children, including minor nieces and nephews. Depending on who the recipient is, the effect of the attribution rules is to tax income or capital gains in the hands of the person who made the original gift, transfer or loan (i.e. the parent). The attribution rules are complicated, but can be avoided with proper planning.

Income Splitting Tax – “Kiddie Tax”

The income splitting tax (or “Kiddie Tax”) was introduced to address certain income splitting strategies. It applies to income splitting arrangements with *minor children*, and not to income splitting arrangements involving adult children (i.e. 18 and over) or a spouse.

The Kiddie Tax targets income splitting through Family Trusts and discourages high-income taxpayers from splitting certain income with minor children, who may have no other income and would therefore otherwise be subject to no tax or tax at low marginal tax rates. In general, income subject to the Kiddie Tax includes:

1. Taxable dividends on shares of *private* Canadian or foreign companies, received directly by the minor child or indirectly through a trust (other than a mutual fund trust) or a partnership;
2. Shareholder benefits or loans conferred on the minor by a private corporation;

[5] *See footnote 4 above.*
[6] *‘Minors’ include children under age 18.*

3. Capital gains realized for the benefit of a minor on a disposition of shares of a corporation to a person not dealing at arm's length with the minor; and
4. Trust income derived by the trust from the business of providing goods or services to, or in support of, a business carried on directly or indirectly by a person or corporation related to the minor child.

The Kiddie Tax also applies to interest, rental and other investment income where a trust provides property to, or in support of, a business carried on by certain relatives. It applies to children who are under age 18 *throughout* the year; a parent is jointly liable with the child to pay the tax.

Tax Rate on Split Income

The effect of the Kiddie Tax is to assess tax to the minor child recipient at the *highest* income tax rate,[7] thereby blocking most or all of the income splitting advantage that would otherwise be available. To illustrate, a person with no other income in a year could receive approximately $40,141 of ineligible dividend income in 2013 from shares of private corporations without incurring any personal tax. This same dividend income (if allocated through a trust) to a minor child without any other income attracts tax of approximately $11,500 in 2013.

The Kiddie Tax has limited the income-splitting benefits for trusts with minor beneficiaries. However, there has remained a minor tax savings benefit. Depending on the level of income, the split income may not be subject to Ontario provincial surtax, which generally starts to apply to an individual taxpayer when taxable income starts at $69,963 in 2013.

Without this surtax, the highest tax rate on normal income, such as interest, is approximately 42.16% in Ontario in 2013. The 42.16% rate is less than the highest marginal tax rate in 2013 for a top tax rate Ontario taxpayer of 49.53%, with surtax. For ineligible dividends from a Canadian company, the marginal income tax rate without surtax in Ontario in 2013 is about 28.82% (as opposed to 36.47% with the surtax). However, the surtax will apply if the minor child has sufficient amounts of other income.

Preferred Beneficiary Election

A trust and a 'preferred beneficiary' can elect to have income of a trust taxed as income of the preferred beneficiary, rather than in the trust, even if the income is not distributed to the preferred beneficiary. The flexibility can lead to tax savings to the extent that the preferred beneficiary's tax position is such that little or no tax would be payable on the income allocated to them.[8] The income (cash) would be physically retained by the trust and under control of the trustees. The income could be ultimately distributed to (perhaps other) capital beneficiaries of the trust as a tax-free distribution of capital.

The election is available only in certain limited circumstances. Generally, the beneficiary must be a Canadian resident and must be *mentally or physically infirm*. Also, the trust settlor must be a spouse, parent or grandparent of the trust beneficiary.

Income Paid or Payable

Trust income can be taxed in the beneficiary's hands if the income is *paid* or *payable* to them. Income could be paid out of the trust to reimburse a parent, guardian or third party in respect of the child, and be taxed to the child.

If the trust is set up for a child under age 21 and the trustees have no discretion in paying amounts out to the child beneficiary (e.g. the unpaid income vests to the child), then the terms of the trust will dictate the timing and amount of income or capital gains payable to the beneficiary. In this case, depending on the terms of the trust, the trustees could retain the allocated income in the trust and under the trustees' control up until the beneficiary reached the age of 40.

In cases where the trust is **discretionary** in nature, the issue of making the income paid or payable is more complicated, and will require the trustees to take steps to allow the income to be taxed to the low-income beneficiaries. Before the end of the trust year, the trustees must decide how to allocate the trust income to the beneficiaries. Also, they must ensure that the income is either paid to the beneficiaries' account or made payable to them. In this regard, in order for the amount to be viewed as payable, the trustees must take positive and irrevocable steps to segregate the income from the trust and have the trust issue promissory notes to the beneficiaries.

There are different ways in which the trust could make a 'payment' to (or for) a minor beneficiary who has been allocated income and/or capital gains:

- The parent could set up an 'in trust' account for the minor and deposit funds from the trust. The 'in trust' account does belong to the child and will be under their control once they turn 18.

[7] *See footnote 4 above.*

[8] *It is important to review whether allocating income to a preferred beneficiary will affect their eligibility for social assistance payments.*

- The trust could make payments directly to third parties for the benefit of the beneficiary, or reimburse the parent for eligible expenses that they paid for the benefit of the beneficiary.

Such eligible expenses include tuition fees for private school, clothing, books, sports or music lessons, summer camps, vacations, sports equipment and other similar expenses for the child's benefit. Only the reasonable portion of the expense would be considered payment made in respect of expenditure for the child's benefit, and can be paid out of trust funds.

The above list of expenses is comprised of items that could be viewed as being beyond the basic necessities of life for the child. Canada Revenue Agency ("CRA") has stated that it would be reasonable for the trust to also pay for the child's necessaries of life. Generally, this means food and shelter.

As such, parents of minor children, who incur and pay for a child's necessaries of life, can receive reimbursements from a Family Trust. Any expenditure must be documented and established as being unequivocally for the child's benefit. A payment or reimbursement will be "ineligible" where household expenditures are totaled and divided by the number of family members.

Readers are cautioned that eligible expenses are not listed in the tax code. Any list represents CRA's administrative policies in this area, and is thus subject to change at any time. Further, CRA has stated that it could assess a benefit to the parents for any payment made by the trust that is not made for the benefit of a minor child beneficiary. The assessment of a benefit to the parent would create a double tax scenario, and thus care should be exercised in this area. In any event, it is important that parents keep accurate records to support any reimbursements of expenses that the trust may pay to them.

Where a child's expenses for which the parents would be reimbursed are less than the amount paid in respect of them by the trust, the excess could be deposited in a bank or investment account maintained for the child (e.g. an 'in trust' account) separate from the trust bank account, or loaned back to the trust at a fair interest rate.

It may be advisable to set up separate trusts, known as "sub-trusts", for the benefit of each minor child. Payments out of a Family Trust could be made to the sub-trust and used by it for investment purposes. All amounts in the sub-trust would vest indefeasibly to that beneficiary and would be payable on demand by the beneficiary (starting when they turn 18) or their guardian.

Taxation of Assets on Transfer to the Trust

With the exception of an "alter ego trust" and a "joint spousal trust", assets transferred to a Family Trust are deemed to be disposed of by the transferor and acquired by the trust at fair market value. As such, a transfer can lead to the realization of significant capital gains, resulting in a tax liability to the transferor for the year of transfer.[9]

For this reason, all assets transferred to the trust should be screened to determine their inherent tax liability. In particular, it would help to choose assets with nominal or low capital gains, or to transfer assets that trigger capital losses to offset capital gains from other assets being transferred. As such, the net capital gains will be low, thereby reducing personal taxes on the asset transfer.

Estate Freeze of Family Business Assets

An estate freeze is used to freeze the value of investment and/or family business assets, transfer future growth in value of the assets to someone else (e.g., other family members), while maintaining control of the asset if so desired. By "freezing" the known value of the assets, the associated capital gains taxes related to the assets is also frozen. Future growth is passed on to others who could die after the "freezer," and thus any income tax on gains accrued after the freeze is deferred.

For private owner-managed companies, using a trust to hold the 'growth' shares affords the owner time to decide which children, if any, will ultimately receive the shares from the trust. In the meantime, if an outside offer to purchase the corporation arises, the owner can still effect a sale of the corporation without complications of having other family members as direct shareholders.

A taxpayer should consider the tax and financial implications of using a discretionary family trust as part of a corporate reorganization or estate freeze. To be of any tax advantage, discretionary family trusts must be irrevocable. Once constituted, it may be difficult to vary the trust; however, trusts may be dissolved by distributing all assets to the capital beneficiaries on a tax-free basis.

Alter Ego and Joint Spousal Trusts

Under certain circumstances, assets transferred to **alter ego** or **joint spousal** trusts can be tax-deferred. These trusts arise when the transferor is at least 65 years of age.

No accrued gains are realized when assets are transferred into the trust, unless the settlor and the trustees elect otherwise. Gains are recognized on actual dispositions by

[9] *Land transfer tax may apply to real estate transfers to the trust.*

the trust, and the alter ego trust is deemed to dispose of its assets at fair market value on the death of the settlor.

To qualify, the settlor must be entitled to receive all income[10] of the trust that arises before death, and no one other than the settlor may receive or obtain use of any of the income or capital of the trust while the settlor is alive.

For joint spousal (or common-law partner) trusts, any of the transferor or spouse or partner can receive the income during their lifetimes or be entitled to capital.

The alter ego trust and the joint spousal trust will have contingent beneficiaries who will receive income and capital of the trust *after* the death of the settlor or the surviving spouse. As the trust assets would not enter the estate, they would effectively bypass probate fees.

21 - Year Deemed Disposition Rule

For tax purposes, trust assets must be treated as if they were disposed of and re-acquired by the trust at fair market value every 21 years. This rule is intended to prevent unrealized capital gains on trust assets from being deferred indefinitely. A deemed disposal of an asset that has appreciated significantly in value could result in a **substantial tax burden** in the trust and could cause a forced sale of trust assets in order to fund the tax liability.

Nonetheless, the tax on a deemed disposal can still be deferred. For instance, the capital gains tax can be deferred where trust assets are transferred to capital beneficiaries; however, this could entail transfer of all the incidents of ownership of the asset, including control. Therefore, it is important to plan accordingly.

Alternatively, depending on the growth in value up to the time of the deemed disposal, the trustees may decide to pay income tax on the accrued capital gain. This choice could be prudent if the accrued gain is low or if tax could be offset by the beneficiaries' capital gains exemptions.

Provincial Probate Tax Savings

Probate fees can arise on the death of an individual when their assets pass from themselves to their beneficiaries.

While not as significant as the U.S. estate tax,[11] all Canadian provinces levy estate administration or probate fees to cover the court costs of validating a deceased's will and confirming the appointment of an executor.

[10]*In an alter ego trust, the income can be taxed in the trust (high rate tax since an inter vivos trust), unless attribution rule applies so that the income is attributed to be settlor.*

[11]*The U.S. levies an estate tax on large estates, subject to a US$5,250,000 exemption in 2013. Should Canada ever introduce a similar estate tax, it is possible that assets owned by a Family Trust would be excluded from this tax.*

For Ontario estates, the tax is charged at ½% on the first $50,000 of estate value and $1.5% on the estate's value in excess of $50,000. For a deceased with an estate value, including principal residence and shares of a private business, worth $1,500,000, Estate Administration Tax would be $22,000.[12] If one has effected an estate freeze, or transferred assets prior to death, then the exposure to the Estate Administration Tax would be reduced.

[12]*Probate may be reduced by using multiple wills for those who have share and/or debt investments in private companies.*

Summary

Trusts have existed for many years, and remain a viable and valuable means to own assets, facilitate tax planning, and allow for income splitting within a family. In estate planning, Family Trusts continue to be a practical vehicle to use as part of an estate freeze, and can serve to expand access to the small business capital gains exemption. For income splitting purposes, subject to the ‘Kiddie Tax,’ certain child expenses can be paid via a Family Trust distribution, rather than out of the parents’ after-tax funds. In addition, a Family Trust allows for flexibility, asset protection and possible estate tax savings.

To examine how these benefits may assist with your own family’s estate or business succession planning, it is recommended that you meet with an income tax professional experienced in trust and estate planning and administration to ensure that you realize the full benefits of such a plan being put in place.